

Management's Discussion and Analysis

As managers of the state of Washington, we offer this narrative overview and analysis of the financial activities for the fiscal year ended June 30, 2004. We present this information in conjunction with the information included in our letter of transmittal, which can be found preceding this narrative, and with the state's financial statements, which follow. All amounts, unless otherwise indicated, are expressed in thousands of dollars.

Financial Highlights

- Total assets of the state of Washington exceeded its liabilities by \$15.6 billion (reported as *net assets*). Of this amount, \$2.5 billion was reported as "unrestricted net assets." Unrestricted net assets represent the amount available to be used to meet the state's ongoing obligations to citizens and creditors.
- The state of Washington's governmental funds reported combined ending fund balances of \$8.2 billion, an increase of \$962 million in comparison with the prior year.
- Unreserved fund balance for the General Fund was \$385 million, or 2.3 percent of total General Fund expenditures.
- The state's capital assets increased by \$1.3 billion while total bond debt increased by \$867 million during the current fiscal year.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the state of Washington's basic financial statements. The state of Washington's basic financial statements include three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. The focus is on both the state as a whole (government-wide) and the major individual funds. The dual perspectives allow the reader to address relevant questions, broaden a basis for comparison (year-to-year or government-to-government) and enhance the state's accountability.

Government-wide Financial Statements - The *government-wide financial statements* are designed to provide readers with a broad overview of the state of Washington's finances, in a manner similar to a private sector business.

The *Statement of Net Assets* presents information on all of the state of Washington's assets and liabilities, with the difference between the two reported as *net assets*. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the state of Washington is improving or deteriorating.

The *Statement of Activities* presents information showing how the state's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, *regardless of the timing of related cash flows*. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave). The Statement of Activities is focused on both the gross and net cost of various activities (including governmental, business-type and component unit). This is intended to summarize and simplify the reader's analysis of the revenues and costs of various state activities and the degree to which activities are subsidized by general revenues.

Both of the government-wide financial statements distinguish functions of the state of Washington that are principally supported by taxes and intergovernmental revenues (*governmental activities*) from other functions

that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of the state of Washington include education, human services, transportation, natural resources, adult corrections and general government. The business-type activities of the state of Washington include the workers' compensation, unemployment compensation and health insurance programs, as well as various higher education student services such as housing and dining.

The government-wide financial statements can be found on pages C-15 – C-19 of this report.

Fund Financial Statements - A *fund* is a grouping of related accounts used to maintain control over resources that are segregated for specific activities or objectives. The state of Washington, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the state can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental Funds. *Governmental funds* are used to account for essentially the same functions reported as *governmental activities* in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on *near-term inflows and outflows of spendable resources*, as well as on *balances of spendable resources* available at the end of the fiscal year. Such information may be useful in evaluating a government's near term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for *governmental funds* with similar information presented for *governmental activities* in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities*.

Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for three major funds and an aggregate total for all non-major funds. The state's major governmental funds are the General Fund, Higher Education Special Revenue Fund, and the Higher Education Endowment Permanent Fund. Individual fund data for each of the non-major governmental funds is provided in the form of *combining statements* elsewhere in this report.

The governmental fund financial statements can be found on pages C-21 – C-26 of this report.

Proprietary Funds. - The state of Washington maintains two different types of proprietary funds. *Enterprise funds* are used to report the same functions presented as *business-type activities* in the government-wide financial statements. *Internal service funds* represent an accounting device used to accumulate and allocate costs internally among the state of Washington's various functions. The state of Washington uses internal service funds to account for general services such as motor pool, central stores, data processing services, and printing services. Because internal service funds predominately benefit governmental rather than business-type functions, they have been included within *governmental activities* in the government-wide financial statements.

Proprietary fund financial statements provide the same type of information as the government-wide financial statements, but in greater detail. The proprietary fund financial statements provide separate information for Workers Compensation, Unemployment Compensation Funds and Higher Education Student Services Fund, which are considered to be major funds, as well as an aggregated total for all non-major enterprise funds. The internal service funds are combined for presentation purposes. Individual fund data for the state's non-major proprietary funds are provided in the form of *combining statements* elsewhere in this report.

The proprietary fund financial statements can be found on pages C-27 – C-30 of this report.

Fiduciary Funds. Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are *not* reflected in the government-wide financial statement because the resources of those funds are *not* available to support the state of Washington's own programs. Washington's fiduciary funds include state administered pension plans. The accounting used for fiduciary funds is much like that used for proprietary funds.

The fiduciary fund financial statements can be found on pages C-31 – C-32 of this report.

Component Units. Component units are entities which are legally separate from the state but which are financially accountable to the state. The state has one major component unit, the Washington State Public Stadium Authority, and four non-major component units. Refer to Note 1 on page C-38 for more detailed information. Individual fund data for the state's non-major component units are provided in the form of *combining statements* elsewhere in this report.

The financial statements for the state's component units can be found on pages C-33 – C-34 of this report.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages C-35 – C-94 of this report.

Other required information. In addition to this discussion and analysis, this report also presents required supplementary information on budgetary comparisons, pension plan funding, and infrastructure assets reported using the modified approach. Required supplementary information can be found on pages C-95 – C-114 of this report.

The combining statements referred to earlier are presented immediately following the required supplementary information. Combining and individual fund statements and schedules can be found on pages 131-189 of the Comprehensive Annual Financial Report (CAFR).

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. For the state of Washington, total assets exceed liabilities by \$15.6 billion at June 30, 2004 as compared to \$14.9 billion at June 30, 2003.

The largest portion of the state's net assets (53.5 percent for Fiscal Year 2004 as compared to 64.3 percent for Fiscal Year 2003) reflects its investment in capital assets (e.g., land, buildings, machinery, and equipment), less any related debt used to acquire those assets that is still outstanding. The state of Washington uses these capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the state of Washington's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

State of Washington's Net Assets

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003*	2004	2003*	2004	2003
Current and other assets	\$ 13,110	\$ 12,155	\$ 15,032	\$ 14,919	\$ 28,142	\$ 27,074
Capital assets	21,294	20,110	1,452	1,280	22,746	21,390
Total assets	<u>34,404</u>	<u>32,265</u>	<u>16,484</u>	<u>16,199</u>	<u>50,888</u>	<u>48,464</u>
Long-term liabilities outstanding	11,325	10,070	18,646	18,140	29,971	28,210
Other liabilities	3,432	3,341	1,891	2,027	5,323	5,368
Total Liabilities	<u>14,757</u>	<u>13,411</u>	<u>20,537</u>	<u>20,167</u>	<u>35,294</u>	<u>33,578</u>
Net assets:						
Invested in capital assets, net of related debt	7,817	9,033	522	543	8,339	9,576
Restricted	3,106	2,283	1,624	1,514	4,730	3,797
Unrestricted	8,723	7,538	(6,199)	(6,025)	2,524	1,513
Total net assets	<u>\$ 19,646</u>	<u>\$ 18,854</u>	<u>\$ (4,053)</u>	<u>\$ (3,968)</u>	<u>\$ 15,593</u>	<u>\$ 14,886</u>

A portion of the state of Washington's net assets (30.3 percent for Fiscal Year 2004 as compared to 25.5 percent for Fiscal Year 2003) represents resources that are subject to constitutional or external restrictions on how they may be used. The remaining balance of *unrestricted net assets* may be used to meet the state's ongoing obligations to citizens and creditors.

State of Washington's Changes in Net Assets

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Program revenues:						
Charges for services	\$ 3,091	\$ 2,801	\$ 6,058	\$ 5,439	\$ 9,149	\$ 8,240
Grants and contributions	8,461	7,716	473	830	8,934	8,546
Total revenues	11,552	10,517	6,531	6,269	18,083	16,786
Program expenses:						
General government	(918)	(812)	-	-	(918)	(812)
Education - K-12	(6,086)	(5,960)	-	-	(6,086)	(5,960)
Education - higher education	(4,216)	(3,750)	-	-	(4,216)	(3,750)
Human services	(9,348)	(8,971)	-	-	(9,348)	(8,971)
Adult corrections	(644)	(658)	-	-	(644)	(658)
Natural resources and recreation	(651)	(732)	-	-	(651)	(732)
Transportation	(1,310)	(1,422)	-	-	(1,310)	(1,422)
Intergovernmental grants	(329)	(341)	-	-	(329)	(341)
Interest on long-term debt	(478)	(415)	-	-	(478)	(415)
Workers' compensation	-	-	(2,389)	(2,617)	(2,389)	(2,617)
Unemployment compensation	-	-	(1,745)	(2,329)	(1,745)	(2,329)
Higher education student services	-	-	(1,130)	(1,051)	(1,130)	(1,051)
Health insurance programs	-	-	(1,044)	(912)	(1,044)	(912)
Other business-type activities	-	-	(951)	(937)	(951)	(937)
Total expenses	(23,980)	(23,061)	(7,259)	(7,846)	(31,239)	(30,907)
Net program expenses over revenues	(12,428)	(12,544)	(728)	(1,577)	(13,156)	(14,121)
General revenues:						
Taxes	13,093	12,202	116	86	13,209	12,288
Interest and investment earnings	294	252	286	1,317	580	1,569
Excess(deficiency) of revenues over expenses before contributions to endowments and transfers	959	(90)	(326)	(174)	633	(264)
Contributions to endowments	46	36	-	-	46	36
Transfers	199	619	(199)	(619)	-	-
Increase(decrease) in net assets	1,204	565	(525)	(793)	679	(228)
Net assets - July 1, as restated*	18,442	18,289	(3,528)	(3,175)	14,914	15,114
Net assets - June 30	\$ 19,646	\$ 18,854	\$ (4,053)	\$ (3,968)	\$ 15,593	\$ 14,886

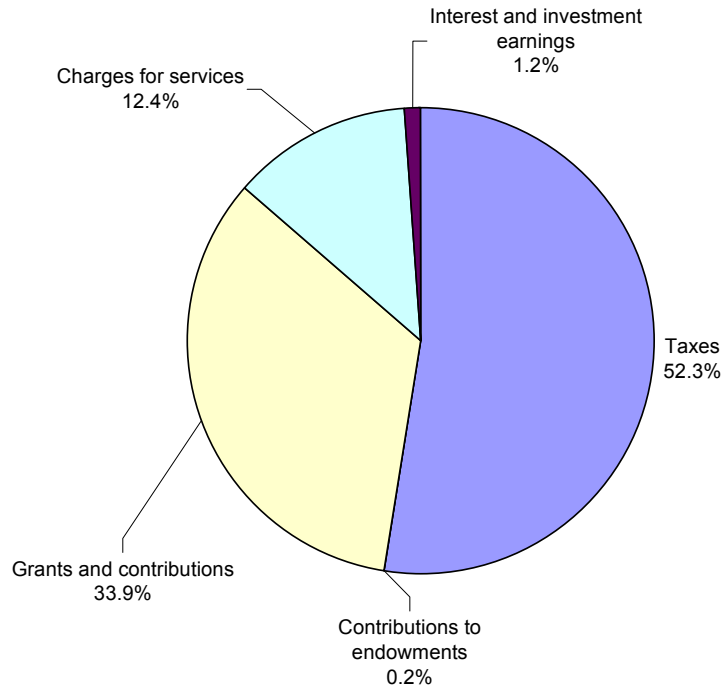
*Note: Net assets as of July 1, 2004, have been restated to reflect fund-type reclassification and prior period error correction.

As previously mentioned, the state's activities are divided between governmental and business-type. The majority of support for governmental activities comes from taxes and intergovernmental grants, while the business-type activities are supported primarily through user charges.

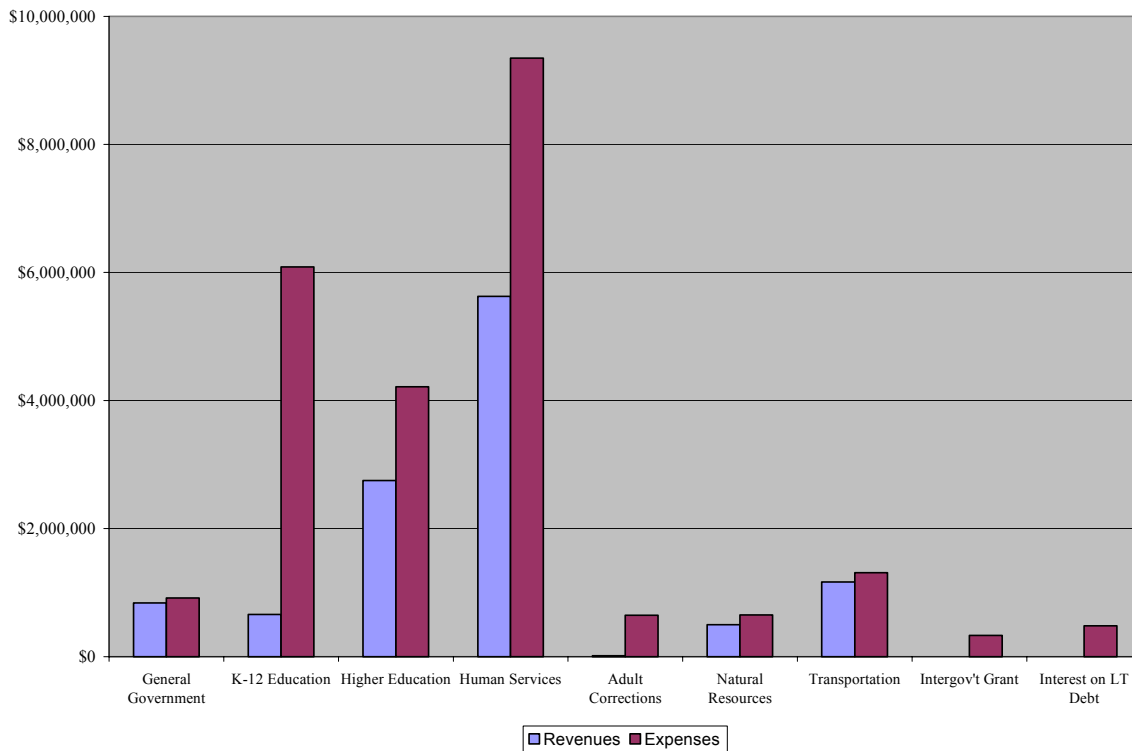
Governmental activities. Governmental activities resulted in a net increase in the state of Washington's net assets (as restated) of \$1,204 million. Key elements of this increase are as follows:

- Receipt of \$102 million in fiscal relief payments under the Federal Jobs and Growth Tax Relief Reconciliation Act of 2004.
- A series of revenue enhancements initiated by the state resulted in increases in taxes, as well as fines and penalties related to delinquent taxes.

Revenues by Source – Governmental Activities

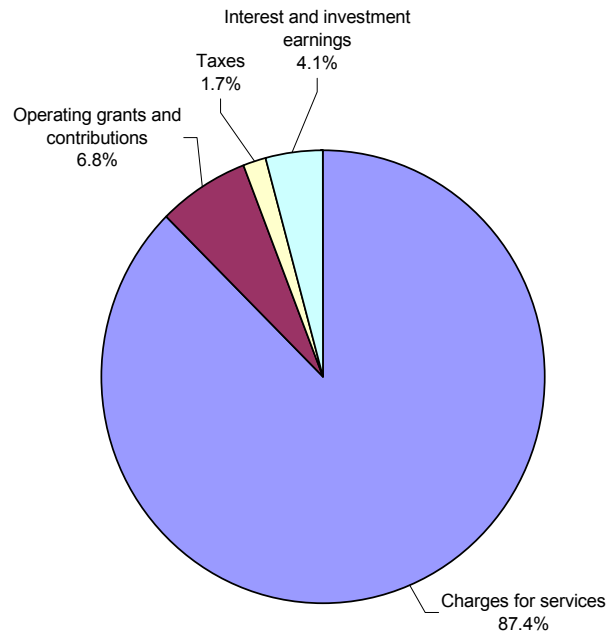


Expenses and Program Revenues - Governmental Activities

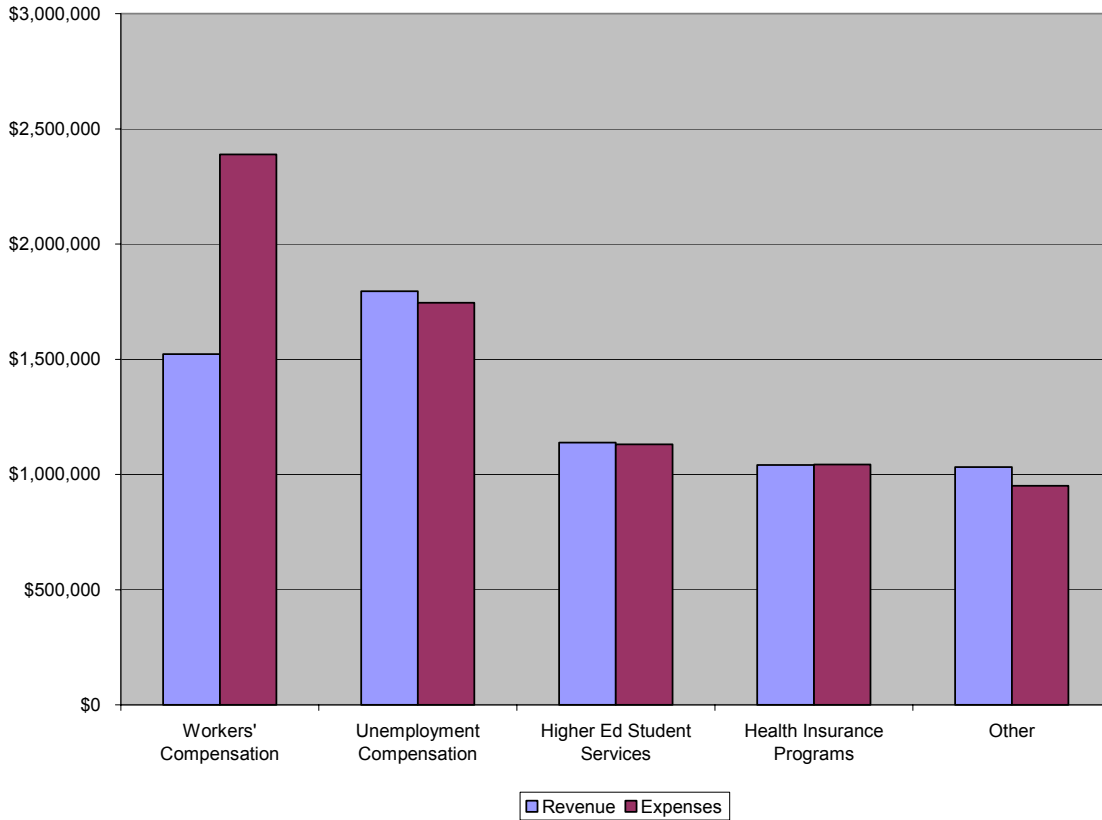


Business-type activities. Business-type activities decreased the state of Washington's net assets (as restated) by \$525 million. The main cause of this decrease was that the workers' compensation program experienced a loss. By law, the supplemental pension cost-of-living adjustments granted for time-loss and disability payments are funded on a pay-as-you-go basis while the related costs are recognized at the time the injury occurs.

Revenues by Source – Business-type Activities



Expenses and Program Revenues – Business-type Activities



Financial Analysis of the Government's Funds

As noted earlier, the state of Washington uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds. As discussed earlier, the focus of the state of Washington's *governmental funds* is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the state of Washington's financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

The General Fund is the chief operating fund of the state of Washington. At the end of the fiscal year, total fund balance for the General Fund equaled \$1.52 billion. Unreserved fund balance, the amount considered available to spend, totaled \$385 million. \$965 million of the General Fund fund balance relates to certain accrued revenues and has been designated for working capital purposes. It is not considered available to spend.

The fund balance of the state of Washington's General Fund increased by \$148 million during the current fiscal year.

State of Washington's General Fund

(in millions of dollars)

	Fiscal Year 2004	Fiscal Year 2003	Difference Increase (Decrease)
Revenues			
Taxes	\$ 11,225	\$ 10,610	\$ 615
Federal grants	5,917	5,354	563
Investment revenue	5	36	(31)
Other	463	498	(35)
Total	17,610	16,498	1,112
Expenditures			
Human services	8,989	8,538	451
Education	6,977	6,911	66
Other	914	890	24
Total	16,880	16,339	541
Net transfers in (out)	(587)	(139)	(448)
Other financing sources	5	11	(6)
Net increase(decrease) in fund balance	\$ 148	\$ 31	\$ 117

The state's recovery from recession combined with state revenue enhancements measures are reflected in increased tax revenue collection. Expenditure growth continues to be limited to services and programs most vital to citizens – primarily health care, public education and economic development.

In addition to the General Fund, the state reports the Higher Education Special Revenue and Higher Education Endowment Funds as major governmental funds. The fund balance for the Higher Education Endowment Fund increased by \$207 million primarily as a result of investment earnings.

Non-major governmental fund revenue increased by \$286 million in Fiscal Year 2004 compared with Fiscal Year 2003 primarily related to tax revenues. This revenue increase combined with a reduction in expenditures resulted in an increase of fund balance of \$447 million.

Proprietary Funds. The state of Washington's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

The Workers' Compensation Fund, Unemployment Compensation Fund and Higher Education Student Services Fund are major proprietary funds. The Workers' Compensation Fund experienced a loss in Fiscal Year 2004 as discussed previously under business-type activities. The Unemployment Compensation Fund reported income of \$111 million in Fiscal Year 2004 compared with a loss of \$374 million in Fiscal Year 2003. This reflects the reduction in the state's unemployment rate. Activity for the various non-major proprietary funds resulted in an increase to net assets of \$38 million. The Risk Management Fund, an internal service fund, ended Fiscal Year 2004 with net operating income of \$39 million.

General Fund Budgetary Highlights

Differences between the General Fund original budget and the final amended budget reflect adjustments to deal with the state's recession and are summarized as follows:

- Estimated tax revenues were decreased \$240 million.
- Estimated revenues from federal grants-in-aid increased by \$495 million.
- Resources provided by transfers in from other funds increased by \$75 million.
- Appropriated expenditures increased by \$568 million.

Differences between the General Fund final amended budget and actual expenditures are as expected at mid-point in the biennial budget – both actual revenues and expenditures approximating half of the estimated/appropriated amount.

Capital Asset, Infrastructure, Bond Debt Administration, and Subsequent Events

Capital assets. The state of Washington's investment in capital assets for its governmental and business type activities as of June 30, 2004, amounts to \$22.7 billion (net of accumulated depreciation). This investment in capital assets includes land, infrastructure, museum and historical collections, buildings and other improvements, furnishings and equipment, as well as construction in progress.

Washington's Fiscal Year 2004 investment in capital assets, net of current year depreciation, was \$1.3 billion, including increases to the state's highway infrastructure of \$782 million and buildings of \$636 million. The state's construction in progress includes both new construction and major improvements to state facilities including correctional facilities, ferry vessels and terminals, and buildings on the capitol and college and university campuses. Remaining commitments on these construction projects total \$2.3 billion.

Additional information on the state of Washington's capital assets can be found in Note 6 beginning on page C-58 of this report.

State of Washington's Capital Assets (net of depreciation) (in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003*	2004	2003*	2004	2003
Land	\$ 1,184	\$ 1,138	\$ 101	\$ 86	\$ 1,285	\$ 1,224
Highway system infrastructure and other assets not depreciated	12,618	11,839	-	-	12,618	11,839
Buildings	4,470	4,037	1,099	896	5,569	4,933
Furnishings, equipment and collections	1,304	1,291	119	90	1,423	1,381
Other improvements and miscellaneous	686	635	46	42	732	677
Construction in progress	1,032	1,163	87	264	1,119	1,427
Total	<u>\$ 21,294</u>	<u>\$ 20,103</u>	<u>\$ 1,452</u>	<u>\$ 1,378</u>	<u>\$ 22,746</u>	<u>\$ 21,481</u>

*Note: Fiscal Year 2003 restated to reflect fund-type reclassification and prior period error correction.

Infrastructure. The state of Washington first reported infrastructure under the requirements of the Governmental Accounting Standards Board in Fiscal Year 2002. Transportation infrastructure reported includes the State Highway System, Emergency Airfields and a short rail line. While the rail line is reported net of depreciation, the State Highway System and Emergency Airfields are reported using the Modified Approach.

Under the Modified Approach, rather than recording depreciation, asset condition is reported. The condition of these assets, along with their rating scales for pavements, bridges and air fields are further explained in the notes and required supplementary information to the financial statements.

The Department of Transportation accomplished a net addition of 25 lane miles, added 13 new bridges and removed 16 bridges in Fiscal Year 2004. In addition, 741 miles of special use lanes and lanes under construction were included in total lane miles for the first time this year. The State Highway System asset value increased by \$782 million during the fiscal year. The State Highway System and Emergency Airfields continue to meet established condition levels. No significant changes in condition levels were noted for pavements or bridges. Amounts spent during Fiscal Year 2004 to maintain/preserve these infrastructure assets were not significantly different from estimated spending plans according to the biennial budget.

Commitments made for infrastructure projects that extend beyond the fiscal year amount to \$730 million representing 914 projects.

Bond debt. At the end of Fiscal Year 2004, the state of Washington had general obligation bond debt outstanding of \$9.3 billion, an increase of 9 percent over Fiscal Year 2003. This debt is secured by a pledge of the full faith and credit of the state. Additionally, the state had authorized \$6.1 billion general obligation debt that remained unissued.

The state had revenue debt outstanding at June 30, 2004, of \$1,009 million, an increase of \$59 million over Fiscal Year 2003. This increase is primarily related to revenue bonds issued by state colleges and universities. Revenue bond debt is secured by specific sources of revenue.

Four times during the year, the state issued general obligation debt, totaling \$1.62 billion for various capital and transportation projects as well as for refunding purposes. The state took advantage of the historically low interest rates that prevailed through Fiscal Year 2004 to do four refunding bonds. These refundings will save taxpayers over \$34.9 million (net present value) in future interest payments. The state ranked 39th in a list of the top 100 issuers ranked by amount financed by municipal issuers in calendar year 2003, according to The Bond Buyer's 2004 Yearbook.

State of Washington's Bond Debt

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
General obligation (GO) bonds	\$ 9,173	\$ 8,376	\$ 155	\$ 172	\$ 9,328	\$ 8,548
Accreted interest on zero interest rate GO bonds	178	153	21	18	199	171
Revenue bonds*	496	502	513	448	1,009	950
Total	<u>\$ 9,847</u>	<u>\$ 9,031</u>	<u>\$ 689</u>	<u>\$ 638</u>	<u>\$ 10,536</u>	<u>\$ 9,669</u>

*Note: Revenue bonds for Fiscal Year 2003 restated to reflect fund-type reclassification and prior period error correction.

The Washington State Constitution and the Revised Code of Washington limit the amount of general obligation (GO) debt that may be issued, the latter being the most restrictive. For the fiscal year ended June 30, 2004, the maximum GO debt authorized by statutory limit was \$6.3 billion. The debt capacity remaining was \$607.2 million. Specific bond issues and types that are not secured by general state revenues, such as motor fuel tax and reimbursable bonds, are excluded from the limitation.

By statutory provision, the State Finance Committee (SFC) is authorized to supervise and control the issuance of all state bonds, notes, or other evidences of indebtedness. The SFC is composed of the Governor, Lieutenant Governor and State Treasurer, the latter serving as chairman.

In January 2004, Standard & Poor's Rating Group (S & P) lowered the rating on Washington's general obligation bonds from AA+ (negative outlook) to AA (stable outlook). No other rating agency actions occurred during the fiscal year.

As of June 30, 2004, the state of Washington's general obligation debt was rated Aa1 (negative outlook) by Moody's Investor Service, AA (stable outlook) by S&P, and AA by Fitch Ratings.

Additional information on the state's bond debt obligations and the calculation of the legal debt limitation is presented in Note 7 beginning on page C60 of this report.

Economic Factors and Next Year's Budgets and Rates

- During the next year, the state is expected to show signs of recovery from the recession that impacted the federal and state economies during recent years.
- Revenue forecasts for the remainder of the 2003-05 Biennium reflect continued growth in General Fund revenues.
- Employment in Washington is expected to show signs of growth higher than the projected national growth rates.

Legislative leaders and management will consider these factors in preparing the state's budget for future years.

Requests for Information

This financial report is designed to provide a general overview of the state of Washington's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Office of Financial Management, PO Box 43113, Olympia, WA 98504-3113.